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# Figuring Your Tax Liability

There are two types of income tax rates: (1) regular rates which apply to all taxpayers, and (2) alternative minimum tax (AMT) rates, which apply only if certain tax benefits, when added back to your income, result in an AMT tax that exceeds your regular tax.

Most taxpayers do not have to compute the regular tax. They find the tax for their income and filing status in IRS tax tables, which are printed in Part VIII of this book.

Computation of the alternative minimum tax is more complicated and requires the preparation of Form 6251.

There are five graduated regular income tax rates of 15%, 28%, 31%, 36%, and 39.6%.

There are two AMT rates: 26% on the first $175,000 ($87,500 for married persons filing separately) of AMT income, after the exemption; and 28% on AMT income over $175,000 ($87,500 for married persons filing separately).

The AMT exemption is $45,000 for married persons filing jointly, $33,750 for single persons and heads of households, and $22,500 for married persons filing separately, although the exemption is subject to a phase-out rule.

# Regular Tax

## ¶23.1 When To Use the Tax Tables

If you file Form 1040EZ or Form 1040A, you use the tax tables in the Tax Organizer in Part VIII of this book to look up your tax liability. If you file Form 1040, you also use the tax tables if your taxable income is *less* than $100,000; if taxable income is $100,000 or more, you use the tax rate schedules shown on the next page.

If you use the tax tables, you do not have to compute your tax mathematically. To use the tables you first figure your taxable income, then turn to your income bracket and look for the tax liability listed in the column for your filing status. Filing status (single, married filing jointly, head of household, married filing separately, and qualifying widow(er)) is discussed in Chapter 1.

You may *not* use the tax tables and *must* use the schedules if you file for a short period (less than 12 months) due to a change of accounting period.

Estates and trusts may not use the tax tables.

***Figuring taxable income.*** By following the line-by-line steps of your tax return, you reach taxable income. If you do not claim itemized deductions, taxable income is adjusted gross income reduced by the standard deduction and exemptions.

If you do claim itemized deductions, taxable income is adjusted gross income reduced by itemized deductions and exemptions.

***Tax credits.*** After applying the tax tables or rate schedules to get your regular tax liability, you may be able to reduce that liability by claiming tax credits such as the dependent care or earned income credits discussed in Chapter 25, or the business tax credits discussed in Chapter 40.

**EXAMPLES**

1. You are single and have an adjusted gross income of $25,945. You claim one personal exemption and the standard deduction.

| | | |
|---|---|---|
| Adjusted gross income | | $25,945 |
| *Less:* Standard deduction | $4,000 | |
| Exemption | 2,550 | 6,550 |
| Taxable income | | $19,395 |

Your tax liability from the tax table is $2,906. The tax is shown in the column for single persons with taxable income of at least $19,350 but less than $9,400.

2. You are married filing jointly, have adjusted gross income of $35,000, itemized deductions of $7,000, and three exemptions.

| | | |
|---|---|---|
| Adjusted gross income | | $35,000 |
| *Less:* Itemized deductions | $7,000 | |
| Exemptions (3 × $2,550) | 7,650 | 14,650 |
| Taxable income | | $20,350 |

Your tax liability from the tax table is $3,056.

## ¶23.2 Tax Rate Schedules

There are five tax brackets: 15%, 28%, 31%, 36%, and 39.6%. *See* the tax rate schedules on the next page. You compute your 1996 tax using the tax rate schedules if either of the following is true:

- Your taxable income is $100,000 or more; *or*
- You file for a short period due to a change of accounting period.

**Effective tax rate on income subject to exemption phaseout and itemized deduction reduction.** If you are considering earning additional income that will subject you to the phaseout of personal exemptions (¶22.15) or the 3% reduction to itemized deductions (¶13.8), the effective tax rate on this marginal income will exceed the specified top rates for ordinary income and 28% for net capital gain; *see* ¶28.2.

**EXAMPLES**

1. You file as a head of household with taxable income of $103,000. You use Schedule Z to figure your tax.

| | |
|---|---|
| Tax on first $83,050 | $19,074.50 |
| Tax on excess $19,950 at 31% | 6,184.50 |
| Total tax | $25,259.00 |

2. You are married and file a joint return with taxable income of $130,000. You use Schedule Y-1 to figure your tax.

| | |
|---|---|
| Tax on first $96,900 | $21,919 |
| Tax on excess $33,100 at 31% | 10,261 |
| Total tax | $32,180 |

## 1996 Tax Rate Schedules: Use ONLY if your taxable income is $100,000 or more. If less, use the Tax Tables in the Tax Organizer

*Schedule X—Use if your filing status is Single*

*If taxable income is:*

| *Over—* | *But not over—* | *The tax is—* | *Of the amount over—* |
|---|---|---|---|
| $ 0 | $24,000 | 15% | $ 0 |
| 24,000 | 58,150 | $3,600.00 + 28% | 24,000 |
| 58,150 | 121,300 | 13,162.00 + 31% | 58,150 |
| 121,300 | 263,750 | 32,738.50 + 36% | 121,300 |
| 263,750 | | 84,020.50 + 39.6% | 263,750 |

*Schedule Y-2—Use if your filing status is Married filing separately*

*If taxable income is:*

| *Over—* | *But not over—* | *The tax is—* | *Of the amount over—* |
|---|---|---|---|
| $ 0 | $20,050 | 15% | $ 0 |
| 20,050 | 48,450 | $3,007.50 + 28% | 20,050 |
| 48,450 | 73,850 | 10,959.50 + 31% | 48,450 |
| 73,850 | 131,875 | 18,833.50 + 36% | 73,850 |
| 131,875 | | 39,722.50 + 39.6% | 131,875 |

*Schedule Y-1—Use if your filing status is Married filing jointly or Qualifying widow(er)*

*If taxable income is:*

| *Over—* | *But not over—* | *The tax is—* | *Of the amount over—* |
|---|---|---|---|
| $ 0 | $40,100 | 15% | $ 0 |
| 40,100 | 96,900 | $6,015.00 + 28% | 40,100 |
| 96,900 | 147,700 | 21,919.00 + 31% | 96,900 |
| 147,700 | 263,750 | 37,667.00 + 36% | 147,700 |
| 263,750 | | 79,445.00 + 39.6% | 263,750 |

*Schedule Z—Use if your filing status is Head of household*

*If taxable income is:*

| *Over—* | *But not over—* | *The tax is—* | *Of the amount over—* |
|---|---|---|---|
| $ 0 | $32,150 | 15% | $ 0 |
| 32,150 | 83,050 | $4,822.50 + 28% | 32,150 |
| 83,050 | 134,500 | 19,074.50 + 31% | 83,050 |
| 134,500 | 263,750 | 35,024.00 + 36% | 134,500 |
| 263,750 | | 81,554.00 + 39.6% | 263,750 |

# Alternative Minimum Tax (AMT)

## ¶23.3 The Purpose of AMT

The purpose of AMT is to increase your tax if the following benefits result in a regular income tax that is lower than the tax that would apply if the benefits were added back to taxable income. You may owe AMT if you claimed:

- **Itemized deductions**, such as taxes, interest on home equity loans used for nonresidential purposes, medical expenses, and miscellaneous job and investment expenses.
- **Tax benefits**, such as certain tax-exempt interest, accelerated depreciation, and incentive option benefits.

There are no specific tests to determine whether or not you are liable for AMT. You must first figure your regular income tax and then see whether tax benefit items must be added back to taxable income to figure alternative minimum taxable income, on which the AMT is figured. If after claiming the AMT exemption and applying the AMT rates of 26% and 28% (*see* the "Key to AMT Rules" on page 368) the tentative minimum tax exceeds your regular income tax, the excess is your AMT liability, which is added to the regular tax on your return.

AMT liability is figured on Form 6251 and is attached to Form 1040. If you file Form 1040A and report tax-exempt interest from private activity bonds subject to AMT, AMT liability, if any, is figured on a worksheet and the AMT is entered on the line for total tax on Form 1040A.

## ¶23.4 Form 6251

You use Form 6251 to compute AMT liability, if any. The following checklist and worksheet will help you determine if you have to use Form 6251. The checklist items are discussed at ¶23.5 and ¶23.6.

| **Items subject to AMT:** | **Check: ✓** |
|---|---|
| 1. Itemized deductions for taxes, miscellaneous expenses, and medical expenses | ❏ |
| 2. Interest on home equity debt used for nonresidential purposes | ❏ |
| 3. Accelerated depreciation in excess of straight line | ❏ |
| 4. Income from the exercise of incentive stock options | ❏ |
| 5. Tax-exempt interest from private activity bonds | ❏ |
| 6. Intangible drilling costs | ❏ |
| 7. Depletion | ❏ |
| 8. Circulation expenses | ❏ |
| 9. Mining exploration and development costs | ❏ |
| 10. Research and experimental costs | ❏ |
| 11. Pollution control facility amortization | ❏ |
| 12. Tax-shelter farm income or loss | ❏ |
| 13. Passive income or loss | ❏ |
| 14. Certain installment sale income | ❏ |
| 15. Income from long-term contracts computed under percentage-of-income method | ❏ |
| 16. Net operating loss deduction | ❏ |
| 17. Foreign tax credit | ❏ |
| 18. Investment expenses | ❏ |

*If you have checked any of the items listed from 3 to 18, fill in Form 6251 to determine AMT liability, if any. If you have checked only item(s) 1 and/or 2, fill in the following worksheet to determine if you have to prepare Form 6251. A sample Form 6251 is on the next page.*

**WORKSHEET** (Use if you checked only item(s) 1 and/or 2)

1. Enter taxable income before exemptions, Line 35, Form 1040. $________
2. If you did not claim itemized deductions, enter the standard deduction claimed on Line 34, Form 1040.

   If you itemized, enter Line 9 (taxes) and Line 26 (miscellaneous deductions) from Schedule A.

   If you claimed interest on a home equity debt taken out after June 30, 1982, and used the loan for a purpose other than to buy, build, or substantially improve your first or second home, enter the amount from Line 10 or 11 of Schedule A attributable to such debt.

   If you claimed medical deductions, enter the smaller of Line 4 of Schedule A and 2.5% of Line 32, Form 1040. ________
3. Add Lines 1 and 2. ________
4. Enter $45,000 if married filing jointly, $33,750 if single or head of household, or $22,500 if married filing separately. ________
5. Subtract Line 4 from Line 3. If zero or less, you do not have to file Form 6251. ________
6. Enter $150,000 if married filing jointly, $75,000 if married filing separately, or $112,500 if single or head of household. ________
7. Subtract Line 6 from Line 3. If zero, enter 0 here and on Line 8. ________
8. Multiply Line 7 by .25 and enter the result, but not more than Line 4 above. ________
9. Add Lines 5 and 8. If the total exceeds $175,000, or $87,500 if married filing separately, you must prepare Form 6251 to determine AMT liability. ________
10. Multiply Line 9 by .26. ________

If Line 10 is equal to or less than the regular tax on Line 38, Form 1040, do not fill in Form 6251. If it is more than Line 38, prepare Form 6251 to determine AMT liability.

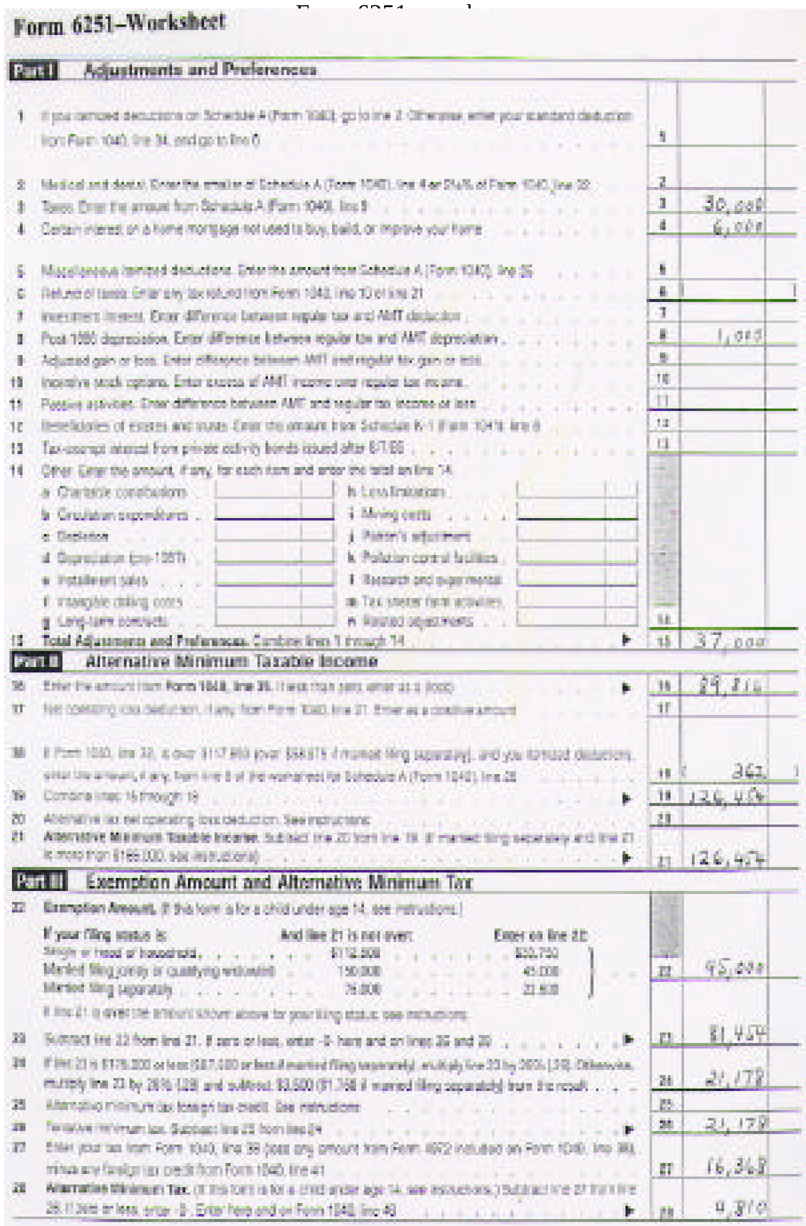
**EXAMPLE**

You are married filing jointly and for 1996 you have adjusted gross income of $130,000. You claim five personal exemptions. The starting point for figuring AMT is the amount shown on Line 35 of Form 1040. This is $89,816, your AGI of $130,000 minus $40,184 of new itemized deductions. Your personal exemptions are ignored for AMT. On Schedule A, you claim itemized deductions of $40,546, which are reduced by $362 under the 3% reduction rule explained at ¶13.8, so that your actual allowable itemized deductions are $40,184. The itemized deductions include $30,000 for state and local taxes and interest of $6,000 on a home equity mortgage loan used for nonresidential purposes (¶23.5). These deductions are adjustments for AMT purposes. You also have an MACRS depreciation adjustment of $1,000. Before figuring AMT on Form 6251, you complete Form 1040 and compute tax liability of $16,368 on taxable income of $77,066 ($89,816 – $12,750 for five exemptions). You prepare Form 6251 (see below) and figure an AMT of $4,810.

## ¶23.5 Adjustments for AMT

The amount of your regular taxable income from Form 1040 (before personal exemptions) will generally be increased by adjustments on Form 6251.

*(Continued on page 369)*



**Form 6251–Worksheet**

**Part I Adjustments and Preferences**

| | |
|---|---|
| 3 | 30,000 |
| 4 | 6,000 |
| 8 | 1,000 |
| 15 Total Adjustments and Preferences. Combine lines 1 through 14 | 37,000 |

**Part II Alternative Minimum Taxable Income**

| | |
|---|---|
| 16 | 89,816 |
| 18 | (362) |
| 19 | 126,454 |
| 21 Alternative Minimum Taxable Income | 126,454 |

**Part III Exemption Amount and Alternative Minimum Tax**

| | |
|---|---|
| 22 Exemption Amount | 45,000 |
| 23 | 81,454 |
| 24 | 21,178 |
| 26 | 21,178 |
| 27 | 16,368 |
| 28 Alternative Minimum Tax | 4,810 |

## Key to AMT Rules

| *Item—* | *AMT Rule—* |
|---|---|
| ***Tax rate*** | A 26% rate applies to AMT taxable income of $175,000 or less (after the AMT exemption) for married filing jointly, $87,500 or less for married filing separately. A 28% rate applies to AMT income exceeding the $175,000 or $87,500 threshold. |
| ***AMT taxable income*** | Regular taxable income without personal exemptions, increased or decreased by adjustments and increased by preferences. |
| ***AMT exemption*** | $45,000 if married filing a joint return (or a qualifying widow(er));<br>$33,750 if single or head of household; *or*<br>$22,500 if married filing a separate return.<br>This exemption is reduced by 25¢ for each $1 that AMT taxable income exceeds $150,000 for joint filers or a qualifying widow(er), $112,500 if you file as a single person or head of household, and $75,000 for a married person filing separately. The exemption is completely phased out at $330,000 on a joint return and $247,500 on a single or head of household return. On a married person's separate return, the exemption is eliminated if AMT taxable income is $165,000 or more.<br>There is also a penalty if, as a married person, you file a separate return and have AMT taxable income exceeding $165,000. You must increase AMT taxable income by 25% of the excess over $165,000, but the maximum increase is $22,500. |
| ***AMT adjustments*** | Itemized deductions for taxes, certain interest, and most miscellaneous deductions are not allowed.<br>Personal exemptions and the standard deduction are not allowed.<br>MACRS depreciation is figured under the alternative MACRS system for real estate using 40-year straight-line recovery, and, for personal property, the 150% declining balance method.<br>Incentive stock options; *see* ¶23.5.<br>Mining exploration and development costs are allowable costs amortized over 10 years.<br>For long-term contracts entered into after February 28, 1986, income is figured under the percentage-of-completion method.<br>Pollution control facilities amortization is figured under alternate MACRS.<br>Alternative tax net operating loss is allowed with adjustments.<br>Circulation expenditures must be amortized ratably over three years.<br>Research and experimental expenditures must be amortized ratably over 10 years.<br>Passive activity losses are recomputed; certain tax-shelter farm losses may not be allowed. |
| ***AMT preference items*** | Tax-exempt interest from private activity bonds issued after August 7,1986, *except* for qualifying 501(c) (3) bonds.<br>Accelerated depreciation on real property and leased personal property placed in service before 1987—excess depreciation or amortization taken over straight-line deduction. |
| ***Adjusted gross income*** | In making AMT computations involving adjusted gross income limitations, use adjusted gross income as computed for regular tax purposes. |
| ***Partnership AMT*** | If you are a partner, include for AMT your distributive share of the partnership's adjustments and tax preference items. These are reported on Schedule K-1 (Form 1065). The partnership itself does not pay alternative minimum tax. |
| ***Trust or estate AMT*** | If you are a beneficiary of an estate or trust, consider for AMT your share of distributable net alternative minimum taxable income shown on Schedule K-1 (Form 1041). The estate or trust must pay tax on any remaining alternative minimum taxable income. |
| ***S corporation stockholder*** | If you are a shareholder, consider for AMT your share of the adjustments and tax preference items reported on Schedule K-1 (Form 1120S). |
| ***Children subject to "kiddie tax"*** | Children under age 14 who are subject to the "kiddie tax" (¶24.3) may have to compute AMT liability on Form 6251. The child's AMT exemption is generally limited to $1,300 plus his or her earned income. Where the child's parent is not subject to AMT because his or her AMT exemption exceeds AMT income, and the child's share of the parent's unused AMT exemption exceeds $1,300, the child's AMT exemption equals that share plus earned income. A child's AMT may be reduced or eliminated if the child's parent or sibling under age 14 had regular tax liability exceeding tentative minimum tax, if any, from Form 6251. By completing a worksheet in the Form 6251 instructions, the child's AMT is limited to the extra tax that the parent would pay if the child's tentative minimum tax liability, plus regular tax, were added to the parents'. |
| ***Nonrefundable credits, such as the child and dependent care credit*** | The amount of these credits may be reduced because of AMT rules explained at ¶23.8. |

***Itemized deductions.*** If you have claimed itemized deductions for state and local taxes or miscellaneous deductions subject to the 2% AGI floor, you must add back all of such deductions to your regular taxable income (prior to personal exemptions) in order to figure alternative minimum taxable income. If medical expenses are deducted for regular tax purposes, you must add back to income on Form 6251 the *smaller* of the allowable medical deduction from Schedule A and 2.5% of adjusted gross income.

Taxes directly deductible from gross income for business or rental purposes remain deductible for AMT purposes. For AMT purposes *only* the following itemized deductions are *allowed:*

- Charitable contributions. However, if you have carryover deductions from contributions of certain appreciated property made before 1993 or tangible personal property before 1991, you must refigure the AMT carryover using cost basis instead of fair market value of the property. The difference between the regular tax carryover deduction and the refigured AMT carryover deduction is entered as a preference item on Form 6251.
- Medical expenses exceeding 10% of AGI. Do not confuse this limit with the 7.5% limit for regular tax purposes.
- Casualty and theft losses exceeding 10% of AGI.
- Unreimbursed moving expenses to a new job location.
- Wagering losses.
- Claim of right deduction; *see* ¶2.9.
- Estate-tax deductions for income in respect of a decedent.
- Impairment-related work expenses.
- Home mortgage interest, *except* for interest on home equity debt, taken out after June 30, 1982, where the loan was not used to buy, build, or substantially improve your first or second home.
- Investment interest to the extent of net investment income.

The 3% reduction computation for itemized deductions at ¶13.8 does not apply for AMT purposes.

***Mortgage interest.*** Less interest may be deductible for AMT purposes than for regular tax purposes. No AMT adjustment is required for home mortgage interest paid on a debt incurred to buy, construct, or substantially rehabilitate your principal residence or qualifying second residence. The residence may be a house, apartment, cooperative apartment, condominium, houseboat, or mobile home not used on a transient basis.

Interest on a mortgage taken out after June 30, 1982, is not deductible for AMT purposes if the proceeds are used for any purpose other than to buy, build, or substantially improve your principal or second residence. Furthermore, in the case of a mortgage refinanced after June 30, 1982, interest is deductible for AMT purposes only to the extent the new debt does not exceed the amount of the old debt immediately before the refinancing. Interest on the excess is not deductible for AMT purposes.

Interest on a mortgage debt incurred before July 1, 1982, for any purpose qualifies for an AMT deduction if the mortgage was secured by your principal residence or any other home used by you or a family member at the time the mortgage was taken out.

If an interest deduction is claimed on Schedule A for debt that does not qualify under these AMT rules, that interest is added back as an adjustment on Form 6251.

***State and local taxes.*** State and local taxes deducted on Schedule A must be added back to taxable income in figuring AMT. If you received in 1996 a refund of state taxes deducted in a prior year, you enter the refund on Form 6251 as a negative adjustment which reduces taxable income in arriving at AMT taxable income.

***Standard deduction and exemptions.*** If you claimed the standard deduction instead of itemizing deductions on Form 1040, you may not claim the standard deduction as an AMT deduction. Exemptions for yourself and your dependents are also not allowed for AMT purposes. The standard deduction is added back to taxable income as an AMT adjustment. Personal exemptions are disallowed by using as the starting point for figuring AMT the taxable income from Form 1040 *before* personal exemptions are claimed.

***MACRS depreciation.*** Less depreciation is allowed for AMT than for regular tax purposes. For property acquired after 1986 other than real estate, the AMT depreciation rate is the 150% declining balance method, switching to the straight-line method when a larger depreciation allowance results. Real property acquired after 1986 is depreciated for AMT over a 40-year period using the straight-line method. Depreciation deductions for films, videotapes, and sound recordings are not adjusted under AMT.

If, for regular tax purposes, you use the regular 200% declining balance method to depreciate business equipment, the difference between the higher regular depreciation and the lower rate for AMT is an adjustment. You may avoid this adjustment by using the 150% rate for regular tax purposes. For real estate, the adjustment is the difference between the straight-line depreciation claimed for regular tax purposes using the recovery period discussed at ¶42.13 and the straight-line recovery over the AMT 40-year recovery period.

The adjustment for MACRS may result in providing more depreciation for AMT purposes where the AMT depreciation computation towards the latter part of the useful life of the property provides larger deductions than the regular MACRS deduction.

**EXAMPLE**

In one taxable year when AMT applies, Jones has two assets acquired after 1986. The regular MACRS depreciation for Asset A is $500 and for Asset B, $400. When applying the AMT rules, the depreciation for Asset A is $400 and for Asset B, $450. AMT taxable income is increased by $50. The adjustment accounts for post-1987 MACRS property held in the current year.

| | | |
|---|---|---|
| Asset A | | |
| Regular depreciation | $500 | |
| AMT depreciation | 400 | $100 |
| Asset B | | |
| Regular depreciation | $400 | |
| AMT depreciation | 450 | (50) |
| Net adjustment to AMT Taxable income | | $ 50 |

Property placed in service before 1987, unless it qualifies under the MACRS transitional rules, is subject to prior law tax preference rules. Prior law creates tax preference items when the ACRS deduction exceeds regular straight line; *see* ¶23.6. A tax preference item always increases AMT taxable income.

***Basis adjustment affects AMT gain or loss.*** When post-1986 depreciable assets are sold, gain for AMT purposes is figured on the basis of the property as adjusted by depreciation claimed for AMT purposes. This gain or loss will be different from the gain or loss figured for regular tax purposes where regular MACRS depreciation was used. (This AMT basis rule does not apply to property placed in service before 1987 except for transitional property within the post-1986 rules).

Similarly, recalculations of basis and gain are made for prior AMT adjustments taken for circulation expenditures, research and experimental expenditures, pollution control facilities, and mining exploration and development costs.

***Incentive stock option (ISO).*** The excess of the fair market value of the shares at the time of exercise over the option price is treated as an adjustment increasing AMT taxable income if you exercise ISO options in 1996, and the shares are freely transferable. When you sell the stock in a later year, and you are subject to AMT in that year, you may increase the basis of the stock for AMT purposes by the amount of the AMT adjustment reported in 1996.

If you exercise an incentive stock option and you sell the acquired stock in the same year, no AMT adjustment is necessary.

***Mining exploration and development costs.*** The deduction allowed for regular tax purposes for mining exploration and development costs is amortized ratably over a 10-year period for AMT purposes.

If a mine is abandoned as worthless, all mining exploration and development costs that have not been written off are deductible in the year of abandonment.

***Long-term contracts.*** The use of the completed contract method of accounting or certain other methods of accounting for long-term contracts is generally not allowable. For AMT, the percentage of completion method must be used. However, there is an exception for home construction contracts.

***Amortization of certified pollution control facilities.*** For purposes of the alternative minimum tax, the amortization deduction for a certified pollution control facility placed in service after 1986 is determined under alternative MACRS; *see* ¶42.9.

***Research and experimental expenditures.*** Research and experimental expenditures must be amortized over 10 years beginning with the tax year in which the expenditures were made.

***Passive losses.*** The law for AMT distinguishes between farm and nonfarm activities. Generally, no loss is deductible for any tax-shelter farm activity. A tax-shelter farm activity is any farming syndicate or any farming activity in which you do not materially participate. You may be treated as a material participant if a member of your family materially participates or you meet certain retirement or disability tests discussed at ¶10.7.

Gains and losses reported for regular tax purposes from tax-shelter farm activities must be refigured by taking into account any AMT adjustments and preferences. However, a refigured loss is not allowed for AMT purposes except to the extent that you are insolvent at the end of the year. The amount of the disallowed loss for AMT purposes may be reduced by the amount of insolvency at the end of the taxable year. This means that you can deduct the loss to the extent of your insolvency. Insolvency is the excess of liabilities over fair market value of assets. Any AMT-disallowed loss is carried forward to later years in which there is gain from that same activity, or until you dispose of the activity.

Passive losses from nonfarming activities are adjusted for preference or adjustment items not allowed for AMT purposes. For example, an adjustment for MACRS depreciation is made directly against the passive loss and is not treated as a separate AMT adjustment item. The loss allowed for AMT purposes is increased by the amount by which you are insolvent at the end of the year. *See* the instructions to Form 6251, which suggest that the AMT adjustment of passive losses be figured on a separate Form 8582 which you do not file.

## ¶23.6 Tax Preference Items

The following are tax preference items that increase the amount of 1996 AMT taxable income.

***Tax-exempt interest on nonessential private activity bonds.*** For AMT purposes, you must include as a tax preference item the tax-exempt interest on qualified private activity bonds issued after August 7, 1986, except for qualified 501(c)(3) bonds used to benefit tax-exempt groups. Generally, private activity bonds issued after August 7, 1986, are subject to AMT, but for certain bonds meeting specific tests, the AMT rule applies to bonds issued on or after September 1, 1986. Interest paid on buying or carrying such bonds is deductible for AMT purposes.

**EXAMPLE**

You received $5,000 interest income from a private activity bond issued in 1992. You also had $100 of investment expense related to this bond. You enter $4,900 on Form 6251.

***Accelerated depreciation of property acquired before 1987.*** For real property placed in service before 1987, the difference between the depreciation that would have been allowable if the straight-line method had been used and accelerated depreciation claimed on real property during the taxable year is a tax preference item. The excess is computed separately for each asset depreciated through an accelerated method. For example, if you use ACRS 15-year, 18-year, or 19-year accelerated rates for regular tax purposes, figure the deduction for each such property under the straight-line method and report the excess of your regular tax deduction over the straight-line amount as a preference item.

For personal property leased to others before 1987, the preference item is the excess of the regular tax deduction over the depreciation that would have been allowed under the straight-line method, without regard to salvage value. The excess is computed separately for each asset. For 10-year property, a 15-year recovery period is used.

***Note:*** *See* ¶23.5 for the MACRS adjustment rules for post-1986 assets.

***Oil and gas preference items generally repealed.*** For tax years starting after 1992, independent oil and gas producers and royalty owners do not have to compute preference items for excess percentage depletion deductions, or for excess intangible drilling costs (only integrated oil companies remain subject to tax preference treatment). *However,* the repeal of the intangible drilling cost preference may result in no more than a 40% reduction in the 1996 AMT taxable income figured as if the drilling cost preference were still in effect and without regard to any AMT net operating loss deduction. *See* the instructions to Form 6251 for making this computation.

# ¶23.7 Net Operating Losses

A net operating loss (NOL) claimed for regular tax purposes must be recomputed for AMT after all other AMT adjustments and preference items are taken into account. An NOL deductible for AMT purposes is generally the amount of the regular net operating loss except that in figuring the nonbusiness deduction adjustment (¶40.19) only AMT itemized deductions are taken into account. Thus, for AMT purposes, state and local taxes and certain interest that are not allowable AMT deductions do not reduce nonbusiness income in figuring the NOL adjustment.

In some cases, a net operating loss will eliminate your regular tax but not the AMT because the loss for AMT purposes is reduced by tax preference items and the amount of the NOL deduction that may be deducted from AMT taxable income may not exceed 90% of AMT taxable income before the NOL deduction and the new energy preference adjustment. Net operating losses that are disallowed because of the 90% AMT limit may be carried back three years or forward 15 years as under regular NOL rules (¶40.17) but the deduction in the carryback or carryover year is subject to the 90% limit. Carryovers from years beginning after 1982 and before 1987 are figured under prior law rules, subject to the 90% AMT limit.

***Deferred minimum tax before 1983 because of NOL.*** If you had minimum tax liability in a pre-1983 year that was deferred because of a net operating loss, you must pay a minimum tax if, in 1996, you claim the net operating loss carryover deduction from that period. The tax is 15% of the net operating loss carryover deduction. You report the tax on Line 46 of Form 1040 and write in "Deferred Minimum Tax."

# ¶23.8 AMT Foreign Tax Credit and Other Tax Credits

The foreign tax credit is the only credit that may be deducted from tentative AMT tax liability. It is figured in the same way as the regular foreign tax credit (¶36.15) after substituting AMT taxable income for regular taxable income.

The AMT foreign tax credit may not offset more than 90% of AMT tax determined without regard to the foreign tax credit and net operating loss deduction. Any foreign tax credit not allowed by the limit may be carried back and forward; *see* ¶36.16 and instructions to Form 6251 for further details.

***Other credits limited.*** If you have AMT adjustments or preference items, the interplay of technical rules and definitions may reduce nonrefundable credits, such as the dependent care credit and the elderly and disabled credit, even when you are *not* liable for AMT after application of the AMT exemption. The amount of such nonrefundable credits is limited to the regular tax liability less the AMT tax liability. The credit limitation is figured on Form 2441 for the dependent care credit, and on Schedule R for the credit for the elderly and disabled.

Certain nonrefundable business credits may also be limited; follow the instructions to Form 3800.

# ¶23.9 AMT Tax Credit From Regular Tax

You may be able to reduce your regular 1996 tax by a tax credit based on prior-year AMT taxes. The credit, which is computed on Form 8801, may be applied against your 1996 regular tax after deducting any credits for dependent care, the elderly or disabled, mortgage interest, foreign taxes, and general business credits. However, the tax credit is allowed only if your regular 1996 tax liability exceeds 1996 tentative alternative minimum tax liability computed on Form 6251.

There are two steps in computing the 1996 credit:

1. ***Recomputing on Form 8801 your AMT liability for 1995.*** On Form 8801, you determine how much of the prior AMT tax was based on "exclusion" items such as the standard deduction, personal exemptions, itemized deductions (such as state and local taxes) not allowed for AMT purposes, percentage depletion, and tax-exempt interest on specified private activity bonds. *No credit* is allowed to the extent your 1995 AMT was based on such "exclusion" items. A credit is allowed only to the extent 1995 AMT was based on "deferral" items such as accelerated depreciation.

   The 1995 AMT from deferral items, if any, is the basic AMT tax credit potentially available for 1996, but the actual credit may be reduced or eliminated because of the tax limitation of Step 2. The potential credit for 1996 is also increased by any carryforward from your 1995 Form 8801 of a credit based on AMT from 1987–1994 that was not allowed in 1995 because of the Step 2 limitation.

2. ***Computing tentative AMT liability for 1996 on Form 6251.*** You transfer the tentative AMT to Form 8801. Your 1996 regular tax, minus tax credits, must exceed the tentative AMT on Form 6251 or no credit will be allowed for 1996.

   If your 1996 tentative minimum tax exceeds your 1996 regular tax minus credits, no credit is allowed in 1996, but a carryover to 1997 is allowed.

# ¶23.10 Avoiding AMT Tax

If you are within the range of the AMT tax, review periodically your income and expenses to determine whether to make certain tax elections, accelerate income, and/or defer the payment of expenses.

There are elections, such as the election of alternative straight-line MACRS depreciation, that may avoid AMT adjustments. However, such elections will increase your regular tax. Similarly, adjustment treatment for mining exploration and development costs, circulation expenses, and research expenses can be avoided by elections to amortize; *see* ¶23.5.

The following steps may also avoid or soften the impact of the AMT tax:

- Defer deductible expense items to a later year in which your income will be subject to regular tax rates exceeding your AMT tax rate (either 26% or 28% depending on your AMT income). Consider deferring payment of home mortgage interest and medical expenses. You will get a larger tax benefit from the deductions in the later year. In the case of unimproved real estate, consider an election to capitalize taxes and carry charges. Also, do not elect first-year expensing of business equipment.
- Defer if possible the exercise of an incentive stock option to a later year when you are not subject to AMT. The bargain element of an incentive stock option is an adjustment item subject to AMT. This is the difference between the option price and the fair market price of the stock on the date of exercise. If you exercise the option and it is subject to AMT, you may find yourself with an unexpected liability and short of liquid funds to meet your tax liability.

***Accelerating income.*** If you find that you will be subject to AMT in a current year, you may want to subject additional income in that year to the 26% or 28% AMT tax rate. In such a case, consider accelerating the receipt of income to that year. If you are in business, you might ask for earlier payments from customers or clients. If you control a small corporation, you might prepay salary or pay larger bonuses. But here be careful not to run afoul of reasonable compensation rules. You might also consider paying dividends.

If you hold savings certificates with a six-month maturity in a later year, you might consider an early redemption to the current year. But here weigh the penalty cost of an early forfeiture. Similarly, you might make an early sale of U.S. Treasury bills to the current year.

If you are certain that you will be subject to AMT you may consider switching some tax-free investments into taxable investments which will give a higher after-tax return after the 26% or 28% AMT tax.